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REPLY COMMENTS BY WILLIAM C. MILLER

(June 1, 2012)

INTRODUCTION

The Postal Service's request to enter into an NSA with Valassis Direct Mail Inc. (Valassis) has stirred major opposition from several stakeholders either in direct competition with Valassis for retail advertising dollars or their representing associations. Initial comments in opposition have been filed by Newspaper Association of America (NAA), The National Newspaper Association (NNA), and several newspapers represented by these two major associations. Additionally, Valpak Direct Marketing Systems, Inc., the Valpak Dealers' Association, Inc. (Valpak) and the Public Representative have filed dissenting comments. Although comments are varied in detail, they generally focus on two aspects of the Postal Service's proposal: a) the discriminatory nature of the proposed NSA against Valassis competitors and the attendant harm created in the market place, and b) the insufficiency of the Postal Service's financial analysis claiming a net contribution gain from the NSA.

Time constraints preclude a detailed response to variations on these two themes made by the parties involved. However, these two issues are addressed briefly below and references are made to initial comments by these parties, as necessary. A preliminary sensitivity analysis is also offered at the end indicating that in contrast to the major losses

that the various interveners speculate the Postal Service would suffer from the NSA, there is little likelihood that this would occur, absent a significant level of fixed administrative expenses.

CONTENTION THAT THE NSA WOULD DISCRIMINATE AGAINST POTENTIAL COMPETITORS AND CAUSE UNREASONABLE HARM IN THE MARKET PLACE

Section 3622(c)(10) of the PAEA states that each NSA submitted for Postal Regulatory Commission (PRC) review shall be "available on public and reasonable terms to similarly situated mailers". The Postal Service has listed eligibility criteria for the NSA which both Valpak and the Public Representative claim are self-serving to only allow Valassis to qualify for agreements at reduced rates and thereby harm other competitors who use saturation and high-density mail for direct mail advertising. [1]

These claims fail to recognize certain operational and economic realities faced by the Postal Service in attempting to craft NSAs with mail users who would qualify as similarly situated. As recognized by the NAA, the single most efficient way for the Postal Service to provide broad benefits to all saturation and high density mail users would be to reduce rates across the board. All mailers and the general public would surely benefit by broader access to direct mail advertising and newspaper inserts. The Postal Service would also avoid the costly burden of negotiating and administering to particular NSAs for certain mailers; not to mention the sure avoidance of charges of discriminatory pricing by excluded mailers. However, there are reasons why the Postal Service has not chosen this seemingly obvious path of least resistance and has instead selected the NSA route for contribution increases by targeting particular markets and mailers.

Although delivery of saturation and high density direct mail pieces are consistently among the most price sensitive services offered by the Postal Service, according to their annually published demand models, demands for these services are still price inelastic. [2]

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[1] Public Representative at 3-7; Valpak at 22-25.

[2] The latest Postal Service demand models for FY 2011 indicate a demand elasticity of -.782 for Standard ECR mail as a whole of which saturation and high density flat pieces are a part.

Pricing within this range of demand responsiveness is the normal expectation in regulated markets where rates are held below monopoly (contribution maximizing) levels. This means that if the Postal Service lowered rates uniformly from current levels, it would lose contribution. Therefore a general price reduction in saturation/high density markets is not a viable strategy, especially when the Postal Service is attempting to conserve cash flow by every possible means.

Another option is to target particular markets where demand elasticity is much higher than the overall average for a collection of markets where uniform pricing is applied. In particular, if demand is sufficiently elastic at current rate levels in these markets (above contribution maximizing levels), then rates can be lowered in these markets only to increase contribution, as long as large scale mail diversion from high to low priced markets is prevented. Therefore to generate the desired two (or multiple) tier pricing system, effective preventive measures need to be put in place and enforced. NSAs offer an obvious contractual means for identifying and implementing the necessary compliance-related measures and enforcement mechanisms that can make such systems work.

Ideally for a particular initiative, in order to spread benefits to mailers competing in targeted markets as widely as possible, the Postal Service would enter into an agreement with a consortium of mailers to reduce rates in targeted markets simultaneously for all parties. However negotiations to enter into an agreement involving multiple mailers would almost certainly prove costly and be doomed from the start for many reasons. Unless geographically segmented, market participants do not necessarily develop a sudden interest to cooperate for the good of all, even with an NSA that has been successfully negotiated. There is always the incentive to gain at the expense of others (just as in illegal pricing cartels), and this incentive can be expected to increase as the number of mailers participating in any agreement increases. This means that Postal Service compliance-related administrative costs would tend to increase disproportionately as mailers are added to an NSA. From the Postal Service's perspective, surely the easiest agreement to monitor successfully and the one requiring the least expenditure of resources (in terms of fixed administrative costs) is one that includes only a single mailer.

If the Postal Service, because of these practicalities, prefers single mailer NSAs, then the provision for similarly situated mailers contained in Section 3622(c)(10) should be considered in the context of the requirement for NSAs to improve the net financial position of the Postal Service. Specifically to consider mailers similarly situated for a future agreement which is functionally equivalent to an NSA which has been successfully concluded, it only makes sense that these mailers exhibit the characteristics that allow the Postal Service to conclude future contribution increasing agreements with them as well. Stated differently, if a particular mailer is considered similarly situated to a mailer who just successfully concluded an NSA, but that mailer is prevented from entering a future agreement with the Postal Service because of ensuing contribution losses, then provisions in Section 36229c)(10) considered as a whole would appear senseless.

The economics that explains when NSA-related contribution increases are possible is straightforward. This is where mailer size and access to national level retail markets matters. It is clear enough that for any NSA to increase Postal Service contribution, the average revenue per piece resulting from a concluded agreement needs to be greater than the average cost per piece. Demand and unit cost schedules for individual NSAs only guarantee this result if Postal Service average unit costs are lower than average piece revenue at some point on the mailer's demand schedule for piece delivery. As mailer demand and Postal Service cost efficiency increases, the volume range over which agreements can be successfully concluded widens. On the other hand, if demand from a mailer is too small, then demand and unit cost curves will not intersect anywhere and a contribution increasing NSA with such a mailer is impossible.

In short, a necessary (but not sufficient) criterion for individual mailers to be considered as similarly situated is that their demands for Postal Service products be sufficiently large for the Postal Service to be able to conclude a contribution increasing NSA with them. The mailer and retailer eligibility criteria which the Postal Service defined in the proposed NSA should be understood in these terms. A hypothetical mailer may now generate a large amount of volume for the Postal Service, but its scope of access to advertising retailers for a targeted NSA market may be insufficiently large to generate a demand for delivery services that is large enough for the Postal Service to benefit. At the

same time, as the Postal Service recognizes, a mailer who does not now generate a large amount of mail but has the potential to access enough retailers to generate a high enough level of demand for delivery services would be a potential candidate for an NSA. It appears that the Postal Service stressed its willingness to discuss potential NSAs with all mailers in this latter category, who do not now meet the annual 400 million piece threshold specified in the proposal, in its response to question 1 of CHIR 2.

ASSERTION THAT THE POSTAL SERVICE WOULD LOSE CONTRIBUTION BECAUSE IT HAS NOT CONSIDERED MAIL MIGRATION TO NSA VOLUMES AND PRIVATE DELIVERY FROM TOTAL MARKET COVERAGE PROGRAMS

Several parties assert that the Postal Service would lose contribution from the NSA because of substantially reduced TCM mailings caused by the NSA. The Public Representative and NNA state that qualifying pieces for the durable/semi-durable goods market under the NSA would migrate from advertisers now using TCM programs.[3] The Public Representative also presents an analysis of the extent of migration possible before the Postal Service loses contribution under this presumption.

On the other hand, NAA claims a broader effect by asserting that if newspapers lose durable goods advertising revenue to Valassis then:

> Newspapers would have to reduce their costs to stay competitive – and although many TMC programs would prefer to remain in the mail, postal rates are one of the few big line items that can be reduced without cutting journalism staff.

Additionally, NAA states:

> As a result, newspapers have told NAA that if that if they suffer revenue losses to Valassis due to the NSA (or due to less revenue from lowering ad rates to retain business), they will reduce their postage expenditures for TMC programs across-the-board, including for mid-week TMC packages that do not include preprints for durable goods. [4]

[3] Public Representative at 8-10; NNA at 10-11.
[4] NAA at 21-22.

However these assertions do not appear to square with the realities of the situation. In fact, market realities strongly suggest that there would be little TCM mail lost by the Postal Service. The vast preponderance of current durable goods advertising business that Valassis might capture is contained in the Sunday inserts now delivered by newspapers in-house. Thus capture of these inserts by Valassis would generate new system volume (added NSA volume with no losses anywhere else in the system). With respect to the mid-week advertising market, Valassis would have little incentive to focus on a market segment it already dominates. Moreover, the Public Representative states that the TMC inserts delivered mid-week by the Postal Service are mostly coupon-related and advertise local grocery store and retail outlet consumable goods; so very little of this mail, if any, would qualify for NSA discounted rates. [5]

Additionally, much of the business generated by Valassis can be expected to be recovered advertising revenue lost by newspapers. A sizeable portion of past advertising revenue has been lost by newspapers because subscriber rates have dropped substantially due to universal access to non-print media. Valassis would be posed to capture this advertising revenue stream through weekend (Sunday) delivery via the Postal Service. Additionally, a general market expansion of durable goods advertising business can be expected simply because of a reduction in advertising rates induced by the NSA. This is entirely new business that never existed.

NAA's assertion that newspapers would cut TMC advertising for non-durable goods as a response to lower revenues caused by any diverted mail is somewhat puzzling. Cutting existing TMC mailings that have nothing to do with durable goods advertising would reduce newspaper bottom lines directly, unless the contribution from this advertising source was already negative. On the other hand, It is certainly possible that a large portion of these mailings could be switched to cheaper private sources, but if so why wait until the Valassis induced revenue loss? These mailings have nothing to do with the NSA and if newspapers can increase cash flow by diverting mail to private delivery now, the rational decision is to do so at the earliest opportunity, not to look for an alleged financial crisis before taking action. In fact, the Public Representative states that newspapers have

[5] Public Representative at 4.

already diverted 40 percent of TMC mailings to private delivery, presumably because they recognize increased cash flow opportunities, previous to and independent of the proposed NSA. [6]

SENSITIVITY ANALYSIS OF EFFECTS OF TMC MAIL MIGRATION

To investigate the mail migration issue in more depth, a sensitivity analysis was conducted to estimate possible first year net contributions from the NSA at various percentages of mail migration for the low and high volume estimates provided by the Postal Service. The analysis assumes that all price induced effects occur in the first year and that out year values, not included in the analysis, would just represent market (retailer participant) growth at the same demand elasticities. Thus results obtained in the first year can be adjusted to any year proportional to the market growth percentage. [7] The results also assume zero fixed administrative costs. Therefore any known fixed costs would need to be subtracted to estimate the net contribution. Detailed results are contained in the spreadsheet accompanying these comments. The Appendix contains an explanation of the formula used to arrive at results shown in each spreadsheet cell.

As shown for the two volume scenarios, contribution effects are calculated by mail migration percentage and percentage of NSA volume already in the base. Averages shown by column represent expected values of contributions assuming that: a) the particular NSA mail percentage, listed as a column heading, is already in the base; and b) each of the mail migration percentages listed by row are equally likely to occur (their probabilities of occurrence are the same). The full average assumes an 80 percent upper bound to the mail migration percentage and the truncated average assumes a 40 percent upper bound (anything above 40 percent has a zero probability of occurring). [8]

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[6] Public Representative at 3.

[7] FY 2011 price and cost data were used for the analysis, so out year estimates would also need to be adjusted by the appropriate inflation indices.

[8] It is also important to note that the various volume percentages assumed in the base are tied to the low volume estimate. That is the first year difference between the low and high volume estimate is assumed to be entirely new NSA volume.

The results show that if a 40 percent upper bound is assumed, then the expected contribution is positive in all cases. For the 80 percent scenario, all expected values are positive, except for a low volume estimate that assumes that more than 40 percent of the estimated NSA volume is already in the base. Thus unless fixed administrative costs are substantial, it appears that positive net contribution from the NSA can be expected. [9]

Respectfully submitted,

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[9] Notice that a market growth adjustment does change all absolute values for a particular year, but not their first year signs (positive or negative) since all values would be multiplied by the same market growth adjustment factor. On the other hand, inflationary adjustments to price and cost data could change the signs of the values, but this is highly unlikely because price and unit cost values tend to grow by the same percentage.

APPENDIX

This appendix explains the calculations used to determine whether the Postal Service can expect a positive contribution from the NSA program. The method explained below follows closely the method explained in the initial comments. However, the present calculation requires adding the TMC sector to the analysis to explain effects from TMC volume diversion. The following extended notation is used in the description.

Notation:

$V_O^{SD} =$ saturation volume for Valassis durable goods advertising at the existing rate,

$V_1^{SD} =$ saturation volume for Valassis durable goods advertising at the discounted rate,

$P_0^{SD} =$ existing rate for saturation durable advertising pieces,

$P_1^{SD} =$ discounted rate for saturation durable advertising pieces

$k = (P_0^{SD} - P_1^{SD})/P_0^{SD}$ = discount factor,

$\pi_0^{SD} =$ contribution from saturation durable goods market at the existing rate,

$\pi_1^{SD} =$ contribution from saturation durable goods market at the discounted rate,

$\epsilon^{SD} = (dV^{SD}/dP^{SD})P_0^{SD}/V_O^{SD}$ = demand elasticity for durable goods saturation market measured at the existing price and volume (P_0^{SD}, V_O^{SD}),

$u^S =$ saturation mail attributable unit cost,

V_O^T = TMC volume at existing TMC (high density) and saturation durable goods advertising rates,

V_1^T = TMC volume at existing TMC rate and discounted saturation durable goods advertising rate,

$P_0^T =$ existing rate for TMC pieces,

$\pi_0^T =$ contribution from TMC pieces at the existing rates,

$\pi_1^T =$ contribution from TMC pieces at the discounted saturation rate,

$\epsilon^{CT} = (dV^T/dP^{SD})P_0^{SD}/V_O^T$ = cross price elasticity of TMC volume with respect to the saturation rate at the existing price and volume (P_0^{SD}, V_O^T),

$u^T =$ TMC mail attributable unit cost,

f = fraction of TMC pieces diverted to saturation volume with discount,
F = NSA fixed administrative expenses.

As before, the initial step is to write first order estimates of saturation and TMC volume changes caused by the change in the saturation piece rate for the NSA eligible advertising. These are:

$$V_1^{SD} - V_0^{SD} \approx (dV^{SD}/dP^{SD})(P_1^{SD} - P_0^{SD}),$$

and

$$V_1^{T} - V_0^{T} \approx (dV^{T}/dP^{SD})(P_1^{SD} - P_0^{SD}),$$

for saturation and TMC pieces, respectively. Note that the cross volume effect of the saturation rate on TMC volume dV^T/dP^{SD} is positive because saturation and high density pieces are substitutes. Therefore the volume change for TMC pieces $V_1^T - V_0^T$ is negative since $P_1^{SD} - P_0^{SD} < 0$. By appropriate substitution, the volume responses can also be written in terms of the respective demand elasticities. We have:

$$V_1^{SD} - V_0^{SD} \approx -kV_0^{SD}\epsilon^{SD},$$

and

$$V_1^{T} - V_0^{T} \approx -kV_0^{T}\epsilon^{CT}.$$

Therefore the after discounted rate volume estimates can be shown as:

$$V_1^{SD} \approx V_0^{SD}(1-k\epsilon^{SD}),$$

and

$$V_1^{T} \approx V_0^{T}(1-k\epsilon^{CT}).$$

Since the actual after-NSA contribution from saturation durable goods and TMC advertising can be written as:

$$\pi_1^{SD} + \pi_1^{T} = V_1^{SD}(P_0^{SD} - P_0^{SD}k - u^{S}) + V_1^{T}(P_0^{T} - u^{T}) - F,$$

substituting the above volume estimates for V_1^{SD} and V_1^{SD}yields the following contribution estimate from these two markets:

$$\pi_1^{SD} + \pi_1^T \approx V_O^{SD}(1-k\epsilon^{SD})(P_O^{SD} - P_O^{SD}k - u^S) + V_O^T(1-k\epsilon^{CT})(P_O^T - u^T) - F.$$

The last expression reduces to:

$$\pi_1^{SD} + \pi_1^T \approx V_O^{SD}[(P_O^{SD} - u^S) - P_O^{SD}k(1+\epsilon^{SD}) + ku^S\epsilon^{SD} + k^2P_O^{SD}\epsilon^{SD}] + V_O^T[(P_O^T - u^T) - k\epsilon^{CT}(P_O^T - u^T)] - F.$$

Then subtracting the existing contributions $\pi_0^{SD} = V_0^{SD}(P_O^{SD} - u^S)$ and $\pi_0^T = V_O^T(P_O^T - u^T)$ from both sides yields the following estimate for the total change in contribution:

$$\pi_1^{SD} - \pi_0^{SD} + (\pi_1^T - \pi_0^T) \approx V_O^{SD}[-P_O^{SD}k(1+\epsilon^{SD}) + ku^S\epsilon^{SD} + k^2P_O^{SD}\epsilon^{SD}] + V_O^T[-k\epsilon^{CT}(P_O^T - u^T)] - F.$$

The first term on the right hand side less the NSA fixed administrative cost F is the contribution change for the saturation market $\pi_1^{SD} - \pi_0^{SD}$ and the second term on the right is the contribution change for the TMC market $\pi_1^T - \pi_0^T$. The first can be positive or negative, but the second is always negative, assuming $P_O^T - u^T > 0$, because of mail migration from the TMC market to the saturation market (reflected by the positive value for ϵ^{CT}).

To calculate an estimate for the contribution change using the above expression, price and unit cost data are available, but other data need to be estimated or a range of values established for sensitivity analyses. First, since none of the Postal Service demand models include cross price demand elasticity estimates, an estimate for ϵ^{CT} needs to be obtained by other means. This can be done by explicitly recognizing some value for f at the margin or introducing a range of possible values for f to examine various possible effects on contribution. Therefore at the margin, we can posit $dV^T/dP^{SD} = -f(dV^{SD}/dP^{SD})$, for some value of f between zero and one. The value for f can never be greater than one. If so, this would indicate a net volume loss to the direct mail industry from a price reduction – a perverse result.

Then from $dV^T/dP^{SD} = \epsilon^{CT}(V_0^T/P_0^{SD})$ and $dV^{SD}/dP^{SD} = \epsilon^{SD}(V_0^{SD}/P_0^{SD})$, we get $\epsilon^{CT}(V_0^T/P_0^{SD}) = -f\epsilon^{SD}(V_0^{SD}/P_0^{SD})$ or $\epsilon^{CT} = -f\epsilon^{SD}(V_0^{SD}/V_0^T)$. Then substituting in the last expression for ϵ^{CT} yields:

$$\pi_1^{SD} - \pi_0^{SD} + (\pi_1^T - \pi_0^T) \approx V_O^{SD}[-P_O^{SD}k(1+\epsilon^{SD}) + ku^S\epsilon^{SD} + k^2P_O^{SD}\epsilon^{SD}] + V_O^{SD}[kf\epsilon^{SD}(P_O^T - u^T)] - F.$$

This can be rearranged to show:

$$\pi_1^{SD} - \pi_0^{SD} + (\pi_1^T - \pi_0^T) \approx V_O^{SD}[-kP_O^{SD} - k\epsilon^{SD}(P_O^{SD} - u^S) + kf\epsilon^{SD}(P_O^T - u^T) + k^2P_O^{SD}\epsilon^{SD}] - F.$$

This last expression can now be used to calculate a range of values for the net contribution effect from the NSA before fixed costs by varying values for V_O^{SD}, ϵ^{SD} and f. Except for any NSA-related fixed costs, all other data are given. The likelihood of a positive contribution after subtraction of fixed costs can then be separately evaluated.

Actually, V_O^{SD} and ϵ^{SD} are related as shown by the definition for ϵ^{SD} above and can be varied jointly through the following procedure. First, assume a strictly linear demand function for the saturation pieces. The corresponding demand elasticity at (P_0^{SD}, V_0^{SD}) can then be calculated as:

$$\epsilon^{SD} = \frac{dV^{SD}}{dP^{SD}}\frac{P_0^{SD}}{V_0^{SD}} = \frac{(V_1^{SD} - V_0^{SD})}{(P_1^{SD} - P_0^{SD})}\frac{P_0^{SD}}{V_0^{SD}}.$$

Because the slope of the demand function is constant, the marginal effect of price on volume dV^{SD}/dP^{SD} at (P_0^{SD}, V_0^{SD}) is always equal to any average effect, including $(V_1^{SD} - V_0^{SD})/(P_1^{SD} - P_0^{SD})$. We know that $k = (P_0^{SD} - P_1^{SD})/P_0^{SD}$, so substituting above gives:

$$\epsilon^{SD} = -(V_1^{SD} - V_0^{SD}/V_0^{SD})/k.$$

Now assume that z fraction of the after discounted rate volume V_1^{SD} is now present as durable goods advertising volume. We therefore have $V_0^{SD} = zV_1^{SD}$ and substituting directly above yields:

$$\epsilon^{SD} = (1 - 1/z)/k.$$

Notice that as z is reduced, given any k value, this implies greater demand sensitivity to lowering the rate by any given amount. Thus the demand elasticity increases as expected to reflect that greater sensitivity. In fact as z continues to be reduced, the demand elasticity increases without limit. [10] On the other hand, if demand does not respond at all to a rate reduction, then $z = 1$ and the demand elasticity is zero.

A range of values for the net contribution effect can now be calculated, exclusive of any fixed costs, using known values for rates and unit costs, the known high and low estimates for V_1^{SD}, the known discount factor value and assumed likely values for f and k. These results are presented in the accompanying spreadsheet.

[10] As z approaches zero where base durable goods advertising volume is also zero, the numerator of the elasticity ratio and the elasticity value itself approaches negative infinity, as expected.